Innovation often comes from improving things that already work. The first automobile was built more than a 100 years ago, and we haven’t stopped improving them ever since.

According to the Energy Information Administration (EIA), the average U.S. car traveled approximately 13 miles on a gallon of gas 50 years ago. Today, we have cars—a Toyota Prius for example—that can travel more than 50 miles per gallon. We even have cars—Tesla’s or Chevy Bolts—that travel hundreds of miles on battery charges.

Tremendous advancements are not unique only to automobiles.

Many things in life work better—or at least more efficiently—than they used to. Simple things like household appliances: coffee pots and microwaves, for example. And even more complicated things like the music we listen to: We can listen to individual songs, rather than owning an entire album.

New Improvements to the Investing Landscape
Investing products—or the wrappers they come in—have charted a similar course. There’s been slight tweaks and improvements over time.

The mutual fund was the fastest growing structure for a period. Then the exchange-traded fund (ETF) came along and started growing at a faster rate. And today, direct indexing is likely to become the fastest-growing investing wrapper, according to Cerulli’s “The Case for Direct Indexing” report.

Direct indexing refers to a separately managed account (SMA) that tracks an index, or a blend of indexes, while holding the individual stocks that comprise the index. While there are many reasons investors might choose direct indexing—the largest common denominator is tax management.

In short, holding all the underlying stocks that comprise an index gives investors the ability to tax-loss harvest in any of the securities trading at a loss held inside that index. Compare this to an ETF where it’s binary: either the ETF you own is positive and you can’t tax-loss harvest, or it’s negative and you can.

Essentially, you have an all-or-nothing proposition with an ETF. Direct indexing creates the possibility for deeper tax-loss harvesting.
Direct Indexing’s Value in a Rising Market

Many intuitively might think direct indexing only works when the market’s going down. But it can work well when markets are trending higher as well.

This year is a perfect example.

Through early September, the S&P 500 is up nearly 18%. But surprisingly, the average stock in the index is only up 7.6%. And nearly 41% of the stocks in the S&P 500 are negative for the year.

**Exhibit 1**

<table>
<thead>
<tr>
<th>S&amp;P 500 Stats</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 YTD TR</td>
<td>18.2</td>
</tr>
<tr>
<td>Avg. Stock Return</td>
<td>7.6</td>
</tr>
<tr>
<td>% Index Positive</td>
<td>58.8%</td>
</tr>
<tr>
<td>% index Negative</td>
<td>41.2%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. Data as of 9/11/2023. Indexes shown are unmanaged and not available for direct investment.

Ultimately, this means that there are potentially many more opportunities to tax-loss harvest!

And we don’t believe this is unique to 2023. While the Magnificent Seven has been a major story—the seven large technology companies driving the majority of U.S. large-stock gains this year—it’s normal for a few very large winners to carry most of the index gains.

This phenomenon does not only exist in large-cap stocks—it’s even more pronounced in small caps. While the S&P 600—a popular small-cap index—is up more than 6% year to date, roughly 50% of the underlying stocks in the index are negative for the year.

**Exhibit 2**

<table>
<thead>
<tr>
<th>S&amp;P 600 Stats</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 600 YTD TR</td>
<td>6.1</td>
</tr>
<tr>
<td>Avg. Stock Return</td>
<td>4.1</td>
</tr>
<tr>
<td>% Index Positive</td>
<td>49.6%</td>
</tr>
<tr>
<td>% index Negative</td>
<td>50.4%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct. Data as of 9/11/2023. Indexes shown are unmanaged and not available for direct investment.

In effect, it’s common to see a significant percentage of equity index constituents negative even when the stock market is going up—which it does in most years. This means direct indexing can be a viable solution regardless of the market environment.
Taking Advantage of Always-On Tax Management

The first step is to partner with a provider that is hyper-focused on tax-loss harvesting. There should be no waiting until the end of the year to begin tax-loss harvesting.

Look for a provider that focuses on tax-loss harvesting just as much on January 15th as it does on December 15th.

A direct indexing approach works best when it’s always on. For example, the majority of accounts Morningstar Wealth manages have realized net losses year to date.

To be clear, this doesn’t mean direct indexing is the best product available. The product investors choose will always be tied to their preferences and suitability.

Two of the top-10 selling cars in the U.S. last year were the Ford F-150 pickup truck and Tesla Model Y. These cars could not be more different than each other. And just as one’s choice of an F-150 or Tesla depends on unique needs, selecting an investment wrapper requires careful consideration of various factors as well.

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About Indexes

The S&P 500 is a market-capitalization weighted index of 500 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrials, financial, utility and transportation companies.

The S&P 600 is a market-capitalization weighted index of 600 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrials, financial, utility and transportation companies.

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Your investment goals matter to us. Our mission is to empower investor success by building investment portfolios selected by your financial advisor. Our world-class investment strategies draw on our core capabilities in research, asset allocation, investment selection and portfolio construction. Our investment professionals are located around the world, which provides both a global point of view and local market expertise.

Based on a proprietary valuation-driven asset-allocation process, our strategies offer investors a range of multi-asset, risk- and outcome-based strategies designed to help meet a variety of goals. Also, our separately managed accounts offer concentrated portfolios of our portfolio managers’ best ideas. We put more than 35 years of investment experience to work in every portfolio we manage to offer you a better investing experience, because your journey matters.

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